

## READING

## THREE CATEGORIES OF COMMERCIAL LOANS

## Loans to finance isolated increases in current assets

Current assets and fixed assets generate cash in different ways. A loan to finance inventory (a current asset) is repaid when the inventory is sold and converted into accounts receivable, which are then collected and converted to cash, generally within one year, depending on the length of the operating cycle of the business. A loan that finances the inventory, therefore, generally is structured to be repaid within one year or less. Similarly, other short-term loans used to finance accounts receivable or other current assets may be outstanding from a few days to one year. Loans to finance current assets often referred to as working capital loans, also support everyday operational expenses. The principal types of short-term loans include special commitment loans, seasonal lines of credit, revolving lines of credit, and letters of credit. These loans are generally repaid by the conversion of current assets through the operating cycle to cash.

**Special commitment loans**, often referred to as time notes, are needed for unusual or special circumstances to support increases in current assets. A business may request a special commitment loan to purchase additional inventory to fulfill an unusually large contract or finance a one-time purchase of close-out inventory. Special commitment loans are generally repaid within 30, 60, 90, or 120 days.

Special commitment loans usually are single payment loans, repaid with cash generated by converting noncash current assets to cash. Before the loan is made, business bankers will stipulate a specific primary and secondary source of repayment. The primary source of repayment (PSOR) typically is conversion of current assets, while the secondary source of repayment (SSOR) is the liquidation of current assets outside of the normal operating cycle. Additional support can come from fixed assets and personal guarantees of the business owners.

*Example:* A manufacturer of tee shirts receives a one-time, large order that requires a special purchase of cotton and other fabrics. The materials cost \$250,000, and the tee shirts will be sold for \$500,000, so the gross profit, excluding labor, realized on the order will be \$250,000. However, the business does not have sufficient cash or availability under an operating line of credit to pay for the materials. One solution to this borrowing need is a special commitment loan, which would supply the necessary working capital until payment is received from the customer. The loan's maturity date should coincide with the manufacturer's operating cycle and the anticipated date of full collection of payment from the customer. If it takes one month to make the tee shirts, which are then shipped immediately to the buyer, who then has 30 days to pay the invoice, it would be unwise to structure the loan for repayment in less than 60 days or more than 90 days.

For the business banker, risks include the business operations, credit policies resulting in lack of payment from the buyer, and inventory with poor material, wrong sizes, or colors. A business banker, therefore, considers secondary repayment sources such as the other current assets of the business, the profitability of the business as a way to repay debt over a longer time period, liens on fixed assets, or injections of capital from the owners or personal guarantees from them.

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**Lines of credit to finance ongoing needs to support current assets**

An operating line of credit is typically used to fund daily operations, and is repaid by converting current assets to cash. The outstanding amount will vary by the daily collection of cash. The facility will generally be reviewed for renewal on an annual basis. In general, an operating line of credit is fairly small in relation to the current assets of the business, and the principal balance frequently reaches \$0, or “cleans up.”

The following are three specialized versions of operating lines of credit:

**Seasonal loans or lines of credit** are short-term and repaid from earnings at the end of a given season. Borrowers, in anticipation of a seasonal surge in sales volume, use seasonal financing to fund a periodic increase in accounts receivable and inventory. Most retailers, for example, rely on a seasonal line of credit to stock up on inventory for the holiday season when, in a period of one quarter, sales can account for 35 to 60 percent of total yearly revenue. Yet, there are risks to the business banker. Will inventory not sell if the season does not happen? Some winters are mild, leaving retailers with seasonal winter clothing inventory that does not sell well, if at all. In the agricultural industry, seasonal credit is used extensively to finance expenses for planting, growing, harvesting, and storing a crop. Once the crop is sold, the loan is repaid by converting noncash current assets to cash.

Any business that has seasonal fluctuations in sales is a candidate for a seasonal line of credit.

Repayment is made by converting current assets to cash, with the expectation that the loan will be repaid when the cash is received or the accounts receivable collected following the peak sales season of the business. The loan’s maturity, therefore, should be tied to the end of the seasonal operating cycle, which typically does not exceed one year.

*Example:* During the spring, an accounting firm that has hired temporary employees to assist in tax preparation is not able to bill its customers as quickly as during normal working periods. The firm requests a seasonal loan to fund labor and the temporary increase in accounts receivable. The loan is structured to be repaid in late May or early June after the tax season has ended. A risk to the business banker is whether any of the accounts receivable will not pay due to poor quality work or poor collection practices. As additional sources of support, the business banker will likely require other collateral of the accounting firm and personal guarantees of the firm’s owners.

**General operating lines of credit** support general working capital needs of a business that tend to be temporary in nature, and not specifically tied to seasonal variations in sales. Because sales tend to be fairly level throughout the year, and to demonstrate that the line usage truly is for temporary working capital needs, the bank may require the line of credit to “clean up” to \$0 for a 30-day period, or “clean down” to some minimum level at multiple points during the year. Depending on how heavily the line of credit is used, the credit arrangement sometimes is supported by a loan agreement that stipulates monitoring by means of monthly submission of aged listings of accounts receivable and inventory reports.

The maturity or renewal point for an operating line of credit generally is one year, set to occur about 90 to 120 days after the borrower’s fiscal year end. This places the financial analysis and loan renewal process as close as possible to the receipt of the fiscal year-end business financial statement. Interest usually is collected monthly.

*Example:* An established manufacturing company has fairly consistent sales from year to year, with strong profit margins in its core line of business. From time to time, opportunities arise to purchase raw materials at favorable prices, and the firm occasionally offers its customers extended repayment terms of sales. These temporary needs for additional inventory and receivables generally are repaid from profits within about 45 days with its operating line of credit fully paying down several times each year and outstandings rarely exceeding 50 percent of the line of credit maximum.

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**Permanent working capital lines of credit** tend to always have a principal balance outstanding, supporting a business that is rapidly growing or with limited capital and long-term debt to support working capital needs. Because the principal balance is often limited to a formula or percentage of current assets serving as collateral, this type of loan is often referred to as a type of asset-based lending.

The principal portion of the loan usually will never be fully repaid as long as the sales volume of the business requires a level of accounts receivable and inventory in excess of its internally generated cash flow. The primary users of permanent working capital lines of credit are rapidly growing businesses that have inadequate cash flow and trade credit to finance the accounts receivable and inventory necessary to support their growing sales volume. A loan agreement with specific terms, such as periodic aged listings of accounts receivable and listings of inventory, usually supports the loans.

These borrowing facilities usually are set up for a specific maximum amount, and may fluctuate from zero to the maximum amount, with draws made as frequently as daily to provide cash necessary to finance operating needs. Reductions to the principal balance come from converting current assets to cash, but with the assumption that there always may be a balance outstanding. The loan is fully repaid either when the sales growth slows or by converting portions of the line of credit to a term loan.

The maturity or renewal point for an operating line of credit generally is one year, set to occur about 90 to 120 days after the borrower's fiscal year end. This places the financial analysis and loan renewal process as close as possible to the receipt of the fiscal year-end business financial statement. Interest usually is collected monthly.

The credit arrangement often is supported by a loan agreement that stipulates monitoring by means of monthly submission of aged listings of accounts receivable, inventory reports, and a formula limiting the principal balance to the level of reported collateral.

**Example:** A wholesale distributor of shoes has experienced a consistent growth in sales nearing \$7,500,000. However, the accounts receivable and inventory needed to support this high sales volume require financing of \$1,500,000, which cannot be supported by current working capital levels. Essentially, the wholesaler's trade credit and equity are insufficient to allow it to operate without constant debt, until profits begin to reduce the borrowing need.

Unlike the accounting firm in the first example, sales fluctuate little from month to month, so the need for financing is somewhat constant. One possible lending arrangement is an operating line of credit, which can finance the shortfall in working capital needed for accounts receivable and inventory. Sales are expected to level off in the next two years. Therefore, the loan probably will be repaid by profit retention and converting portions of the principal balance to a term loan.

The risks for the business banker are that the business is not profitable due to lack of cost controls, and cash flow is weakened by the failure to sell the inventory and collect the accounts receivable. Other sources of support are other collateral the business may own or personal guarantees of the owners.

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## Loans to finance fixed assets

Loans to finance fixed assets are considered long-term debt on the balance sheet of the borrowing business. Long-term debt generally is debt maturing in more than one year, generally three to seven years or more. Loans of this duration and purpose also are called long-term financing or long-term loans. Borrowers typically use long-term loans to finance fixed-asset purchases, business mergers, or other major acquisitions. The full amount of a long-term loan is usually disbursed at one time, with the principal and interest repaid in installments according to a regular, pre-determined schedule. Sometimes, several disbursements can be made in short intervals, for example, when a company purchases several pieces of equipment being financed by a single promissory note. The primary types of long-term financing are term loans, lease financing, mortgages, and construction loans.

**Term loans** are scheduled to mature in more than one year, with repayment usually in monthly installments, with quarterly or annual installments in certain situations. Term loans are used to purchase equipment, furniture, leasehold improvements, vehicles, and most other fixed assets not defined as real estate.

A business banker matches the loan's amortization schedule to the cash flow generated by normal business operations, and generally no longer than the estimated useful life of the equipment. Although term loans usually are amortized over several years, some carry a shorter maturity point (called a balloon or bullet maturity) to allow the bank to review and perhaps renew the loan with alterations in the conditions, if there has been a significant change in the borrower's credit. Another purpose of a balloon or bullet maturity can be to adjust the interest rate on the loan. The bank offers fixed interest rates for periods that are shorter than the appropriate amortization of the loan.

The down payment amount required of the borrower varies, depending on the useful life of the fixed asset and the bank's lending policies for fixed asset loans. Occasionally, 100 percent financing is arranged if the business has equity in other assets or requests an unusually short amortization period. Otherwise, the repayment amortization usually depends on the depreciable and useful life of the assets financed, plus the borrower's cash flow available for debt service. Term loans are repaid from net profits and cash flow generated over multiple completions of the operating cycle of the business.

**Example:** A commercial printing company wishes to replace one of its older printing presses with a new six-color, digital printing press. The equipment, which costs \$1,000,000, should last at least 15 years. The purchase is financed by a term loan with an amortization of 8 years and a maturity of 5 years. Because there is very little fluctuation in cash flow over the course of the printing company's operating cycle, the loan is structured so that payments are made in equal monthly amounts. The balance, which matures in five years, either can be renewed or paid in full at the bank's discretion.

The risks to the lender for a term loan include the time it takes for the business to complete multiple operating cycles, on-going profitability and operating cash flow of the business, credit and collection policies, inventory management, and the possible specialized nature or limited market for the equipment. To further support the loan, a business banker should consider a loan agreement with covenants and personal guarantees from the business owners. (You will study loan agreements and covenants later in this curriculum).

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**Lease financing** is also used to finance fixed assets, but with several features that can be an advantage over term loans. Since a lease provides 100 percent financing of an asset, it helps new or growing companies with little capital available for a down payment. In other situations, rent (lease) expense may provide a tax advantage compared to owning the asset with related depreciation expense combined with a term loan and interest expense. In still other situations, leases can be short-term and give the business a way to periodically upgrade equipment subject to frequent technological advances. A non-bank leasing company may also provide servicing and repairs to the underlying equipment during the course of the lease.

The following lease terms and features are listed below:

- A lease is a contract giving the right of use and possession of an asset for a specific period in exchange for payments
- The party owning the leased property is the lessor
- The party using the property is the lessee
- A lease contract may be written for a single piece of equipment, or it may be a master lease governing a continuing arrangement, regardless of the equipment leased
- Depending on the terms of the lease, asset ownership may transfer to the lessee once the lease ends
- As owner of the asset, the lessor enjoys certain tax advantages such as depreciation expense deductions for income tax purposes

Similar to a term loan, a lease is repaid from excess cash flow from the completion of multiple operating cycles of the borrowing business. Because of the higher risk caused by lending nearly 100 percent, some leases are priced higher than a conventional commercial term loan.

**Example:** The owners of a rental car company plan to extend operations and need to add 50 cars to their fleet. For tax and cash flow reasons, the owners wish to carry the fleet as a fully deductible business expense rather than depreciate the asset cost over several years. Lease financing is arranged, with the leases paid from cash earned through expanded operations. Because the lessor assumes the risk that the cars could accumulate high mileage and their condition could deteriorate, the lease payment stream is structured to fully pay for the cars over the lease's term.

Additional risks of lease financing are similar to those of conventional term loans. These risks include the time it takes for the business to complete multiple operating cycles, on going profitability and operating cash flow of the business, credit and collection policies, inventory management, and the possible specialized nature or limited market for the equipment being leased. To further support the lease, the lease financing company or bank may require personal guarantees from the business owners.

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**Mortgage loans** are a special type of term loan that finance the purchase of business properties. Because buildings and land have a long useful life and carry large financing costs, most mortgage loans are structured for repayment over 15 or 20 years. Payments, which usually are made on a monthly basis, follow a defined amortization schedule, with the portion applied to the interest declining each month and the portion applied to the principal increasing. Monthly payments may be fixed or, in an adjustable rate mortgage loan, may decrease or increase over time.

Commercial mortgage loans for non-owner occupied properties are repaid from rent received on the property from unaffiliated third parties. For owner occupied properties, the primary source of repayment is the cash flow from the completion of multiple operating cycles of the borrowing business that owns the property. In both situations, collateral consists of the real property, such as farmland and buildings, commercial land and buildings, and office condominiums.

Mortgage loans can also serve as the primary source repayment for construction loans. In some situations, a bank will approve both a construction loan and a “permanent” mortgage loan for a business that needs to construct facilities for its operations.

**Construction loans** are made to finance the costs to construct real property and are for a shorter period. Generally, the loan is made for up to 60 days past the estimated construction period. A common arrangement is for a bank to extend a construction line of credit to the borrower, to be drawn on over the life of the construction project. Principal draws usually are controlled by requiring the borrower to submit proof of construction expenditures, along with a methodology by the lender to inspect the property to assure that adequate work has been completed to justify the loan draw. The borrower makes monthly interest payments during the course of construction.

Once the construction of a plant or building is completed, a construction loan often is converted into a mortgage loan at the same bank, or perhaps another lender. If the same bank offers the mortgage loan, then after the project is completed, the line of credit is converted to a mortgage loan, and the borrower begins making payments on the principal and interest.

*Example:* A flower shop’s lease has been terminated, and the owner must relocate the business. Rather than enter into another lease agreement and possibly have to move again, the owner decides to build a store on land she owns. The owner obtains a \$650,000 construction loan, with funds to be advanced during the various stages of the project, based on work completed by a qualified general contractor. Completion is expected to be within one year, during which time payment will be interest only. Upon completion of the project, the loan will be converted to a mortgage loan, to be repaid in equal monthly installments over a 15-year amortization. The mortgage loan is structured with a balloon feature, with maturity in five years, at which time the loan can be renewed and a new interest rate negotiated.

The risks of owner occupied mortgage loans are similar to those of term loans and lease financing, namely the time it takes for the business to complete multiple operating cycles, on-going profitability and operating cash flow of the business, credit and collection policies, inventory management, and the possible specialized nature or limited market for the property. To further support the loan, a business banker usually will require personal guarantees from the business owners.

The risks of non-owner occupied properties include the credit quality of the businesses or individuals that are paying rent, the nature of the rental agreements, market conditions that affect the ability to lease the property, and the owner’s ability to properly manage and maintain the land and building.

For construction loans, additional risks come from the ability to complete the property per plans and specifications, on time and within budget.

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The following chart summarizes the types, purposes, repayment sources, and risks for each loan structure.

<b>Commercial Loan Structure Summary</b>			
<b>Loan Type</b>	<b>Purpose</b>	<b>Repayment</b>	<b>Risks</b>
<b>Loans to finance isolated increases in current assets</b>			
Special commitment	Isolated increases in current assets	Short-term, often single payment, based on conversion of current assets	Business operations, credit policies, inventory quality
<b>Lines of credit to finance ongoing needs to support current assets</b>			
Seasonal line of credit	Operating expenses and seasonal increase in current assets	Conversion of current assets, and should be fully repaid shortly after end of season	Sale of inventory, credit, and collection policies
General operating line of credit	Temporary, non-seasonal increases in current assets	Conversion of current assets, evidenced by substantial periodic principal reduction	Sale of inventory, credit, and collection policies
Permanent working capital line of credit	Permanent increases in current assets	Conversion of current assets combined with excess cash flow from completion of multiple operating cycles; conversion to term loan	Sale of inventory, credit and collection policies, cost controls
<b>Loans to finance fixed assets</b>			
Term loan	Purchase or refinance equipment, furniture and fixtures or leasehold improvements	Excess cash flow from completion of multiple operating cycles	Time it takes for complete multiple operating cycles, on-going profitability, and operating cash flow, credit and collection policies, inventory management, and possible specialized nature or limited market for asset or property
Lease financing			
Mortgage loan	Purchase or refinance commercial property	<i>Owner occupied:</i> Excess cash flow from completion of multiple operating cycles <i>Non-owner occupied:</i> Rental income	
Construction loan	Construct or improve commercial property	Conversion to mortgage loan	Control of draws, completion on time, within budget, and consistent with plans and specifications